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RUEHDK/AMEMBASSY DAKAR 2008
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AF/S FOR G.GARLAND
ADDIS ABABA FOR USAU
ADDIS ABABA FOR ACSS
COMMERCE FOR BECKY ERKUL
TREASURY FOR J. RALYEA AND T.RAND
NSC FOR SENIOR AFRICA DIRECTOR B.PITTMAN
STATE PASS TO USAID FOR L.DOBBINS AND E.LOKEN

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Summary

¶1. (SBU) The liquidity crisis that gripped Zimbabwe's banking sector at the end of 2007/early 2008 has abated thanks primarily to high election-related government expenditure. On the other hand, borrowings associated with the funding of these expenditures along with concessionary finance facilities offered by the Reserve Bank have led to explosive growth in money supply and hyperinflation. Commercial lending has almost dried up for lack of bankable projects and due to the Reserve Bank's pervasive subsidized lending, leaving bank assets dominated by zero-risk-weighted treasury bills. Consequently, credit risk within the banking sector is almost non-existent. In regard to recent new minimum capitalization requirements, banks have complied mainly by re-valuing their property at favorable, but deeply distorted, exchange rates, leading them to appear well capitalized, at least in the short term. Once the GOZ implements sound macro-policies and lending to the private sector resumes, however, they will need recapitalization and some consolidation within the sector can be expected. (End Summary)

Government Spending Resolves Liquidity Crisis

¶2. (SBU) John Mushayavanhu, Deputy President of the Banker's Association of Zimbabwe, told us that bank liquidity had improved dramatically in the past four months as a result of high government expenditure associated with the June 27 presidential run-off and post-election populist policies. Government spending is channeled through the formal banking sector and thus provides liquidity to the

banks. The spending spree compensated for the banks' inability to offer real positive interest rates on deposits. Real interest rates are, in fact, so low that cash-rich clients pour their money into the Zimbabwe Stock Exchange rather than into the money market. Buoyed by the inflow, the Industrials index on September 4 had risen 527 million percent since January 1 and the Mining Index was up 436 million percent.

RBZ Applies Punitive Instruments

¶3. (SBU) Typical of monetary policy since Gideon Gono became Reserve Bank Governor, the RBZ continues to accommodate the government's lax fiscal policy. Government's demand for credit from the monetary banking sector has been the main cause of the exponential growth in Zimbabwe's money supply as the RBZ covers its losses from its quasi-fiscal activities by printing money.

Punitive Statutory Reserve Requirements...

¶4. (SBU) Notwithstanding that the RBZ itself is the source of monetary expansion, it has addressed the consequent problem of inflation by hiking bank statutory reserve requirements to levels well above the international norm. Statutory reserves serve as a fallback to depositors should a bank be threatened by a run on deposits. Mushayavanhu told us banks were lobbying for a substantial reduction in statutory reserves from the average of

about 50 percent to the internationally accepted level of around 10 percent, since Zimbabwe already had in place a deposit insurance scheme to protect its depositors. (Comment: We don't expect the RBZ to lower statutory reserves by much, as the RBZ uses them to fund subsidized lending. End Comment)

¶5. (SBU) In addition, the RBZ employs harsh terms for settling overnight accommodations for institutions that are either caught short or have excess funds at the end of any trading day. For institutions that are caught short, the accommodation rates are 8,500 percent and 9,000 percent per night. Being caught with excess funds is equally onerous: The excess is swept into non-interest bearing 90-day non-negotiable certificates of deposits (NNCD). (Note: Until January 31, 2008, NNCDs had an even more punitive 270 day maturity which had rendered liquidity management a nightmare for most banks. End Note). ZB Financial Holdings Chief Economist Best Doroh told us that bank borrowing from the RBZ had been the norm earlier this year until high government expenditure put the banks in a surplus position.

No Credit Risk

¶6. (SBU) Doroh and Mushayavanhu each commented that bank lending on commercial lines had all but collapsed since introduction of the RBZ's concessionary facilities. Barclays bank and CFX bank half year results, for example, show that advances fell by 94 and 96 percent respectively between June 2007 and June 2008. Not only was there a dearth of bankable projects due to the poor macroeconomic environment, but most loans and advances were made under the RBZ's Agriculture Sector Productivity Enhancement Facility (ASPEF) and Basic Commodity Supply Side Intervention (BACOSSI) facilities at 25 percent interest per annum. With the official rate of inflation for June 2008 at 11.2 million percent, and the actual rate in the billion percent range (reftel), the real return on concessionary lending is deeply negative.

¶7. (SBU) Moreover, government borrowing from the monetary banking sector through treasury bills (TBs) has left the sector holding significant amounts of very low yielding (currently 340 percent per annum) TBs, for lack of acceptable alternative assets. Financial results show that, on average, bank loans and advances accounted for only 15 percent of the total assets of the banking sector at end

December 2007-a very low percentage considering that loans and advances constitute the core function of banks. In addition, of this small amount, the bulk was ASPEF and BACOSSI lending.

¶8. (SBU) Doroh and Mushayavanhu each said separately that banks were also involved in very short-term lending through bankers acceptances at rates between 25 and 30 percent either overnight or for up to 30 days as a way of avoiding locking up funds for 90 days in the RBZ's non-interest bearing NNCDs. Mushayavanhu explained that credit risk was therefore non-existent as the loan book did not contain doubtful clients who might default on their obligations. Doroh shared this view, stating that ZB Bank screened lending rigorously to minimize default risk.

¶9. (SBU) Doroh said that banks indulged in non-core activities to preserve their capital base and hedge against inflation: They bought and sold shares on the stock exchange, traded in property, and traded in foreign exchange. Indeed, Fulton Chibaya, the Chief Executive Officer of Genesis Bank told us that the partial liberalization of the foreign exchange market introduced on April

30, 2008 had contributed to resolving the banks' liquidity problems as they could sell foreign exchange when short on any trading day. He also noted that banks with immobile assets and shares were turning out high unrealized profits through fair value adjustments thereby boosting their balance sheets. Although the liquidity situation had improved, Doroh said the challenge of poor returns nevertheless remained.

Minimal Foreign Exchange Risk

¶10. (SBU) Zimbabwean banks do not extend foreign currency loans because of the binding foreign exchange constraint in the economy. As a result, foreign exchange risk is minimal except for banks' difficulty in obtaining foreign exchange to pay for computer hardware and software licenses. In that regard, in the past year U.S. debt collectors have called on post to express interest in a half dozen cases in which Zimbabwean banks and telecommunications companies could not access foreign exchange to pay for their IT licenses.

Fraud Poses Greater Risk

¶11. (SBU) Mushayavanhu viewed internal fraud as the major risk facing banks in the prevailing hyper-inflationary environment, as salaries have collapsed in real terms. Godfrey Kanyenze, Director of the Labor and Economic Development Research Institute of Zimbabwe (LEDRIZ) concurred, and added that the collapse in earnings had also triggered massive skills flight.

Higher Capital Requirements Pose Little Challenge

¶12. (SBU) Mushayavanhu said that as of June 2008 all banks had met the new minimum capital requirements effective September 1, 2008 of US$12.5 million for commercial banks, US$10 million for merchant banks and building societies, US$7.5 million for Finance and Discount Houses, and US$2.5 million for Asset Management Companies, calculated in local currency at the inter-bank exchange rate. Most of the banks held properties that had been revalued in US$ terms, allowing them to meet the new capital requirements easily. James Mushore, co-founder of NMB Bank, told us that NMB, for example, had met the requirement in this way. CBZ Holdings' Finance Director Never Nyemudzo indicated that CBZ Bank was sitting on a capital base of US$42.48 million and its building society on a base of US$48.96 million. Mushayavanhu stated that most banks had capital adequacy ratios of 200 percent, which is ridiculously higher than the Basel standard of just about 10 percent, indicating that the banks are not deploying their assets effectively.

Comment

¶13. (SBU) Banks are currently enjoying the benefits of high market liquidity stemming perversely from high government expenditure, but the downside risks associated with a return to sound macroeconomic policies are high. Government expenditure will inevitably fall and money market conditions tighten, forcing banks to manage liquidity more prudently. Lending to the private sector will also likely pick

up as companies borrow to upgrade plant and equipment. To the extent that interest rates will rise in the first instance, increased lending will bring with it interest rate risk as well as credit risk. Moreover, we foresee a massive devaluation of the Zimbabwe dollar to offset the high inflation differential between Zimbabwe and its trading partners. Banks are likely to obtain foreign lines of credit for their clients, which will require that they set aside some capital to cover foreign exchange risk. Clearly, when Zimbabwe undertakes the necessary reforms and banks re-engage in their core businesses, they will have to recapitalize substantially and return to active asset and liability management to remain viable. In this regard, some consolidation within the sector is likely given the sharp contraction of the economy over the past ten years. Small indigenous banks, in particular, are likely to merge in order to raise required capital. End Comment.

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